FHBs (formerly known as FHLs)

Julie Butler considers the impact of recent changes to the UK Furnished Holiday Lets rules

ABOUT THE AUTHOR

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Furnished Holiday Lets (FHLs) rules are due to change from 6 April 2010.

There will be a loss of CGT and income tax relief for FHL owners.

The announcement came in the UK Budget on 22 April 2009 and certainly has created a stir amongst holiday cottage owners and their advisors.

There is no doubt that there has been some serious debate and lobbying by major holiday cottage groups, tourism groups and the Country Land and Business Association to overturn the decision.

It has been promoted that there was no advance discussion before 22 April 2009. However, the government via Stephen Timms, the Financial Secretary, have promoted that this will be discussed at the time of the forthcoming pre Budget Report before the introduction of the measure in *Finance Bill 2010*.

Fairness for residential landlords

One point raised by Stephen Timms is fairness to the residential landlord. It appears he considers that many residential landlords provide services and undertake activities similar to the FHL landlords. Perhaps that is a whole separate subject for debate – it provides to lead and give direction to the thinking that must arise from the proposed changes.

The new thinking for genuine cottage businesses is to forget the concept of landlord and letting and instead consider:

- 'A' – Adventure in the nature of trade
- 'B' – Business

FHL tax relief restricted to income tax and capital gains tax (CGT)

There must also be the consideration of the fact that the FHL rules only present advantages of income tax and CGT relief AND they had to be commercial. Inheritance tax (IHT) relief via business property relief (BPR) was, and is, a separate subject. The consideration has to be: think business, forget landlord and think on the concept of a hotel and the provision of services.

So what tax reliefs will apparently be lost from 6 April 2010?

1. The sale of the FHL business will no longer be eligible for the following capital gains tax reliefs:

(a) entrepreneur's relief (which reduces the taxable gains on the sale of a business to an effective 10 per cent rate from an 18 per cent rate);

(b) roll-over relief (which allows gains arising on the sale of business assets to be deferred if the proceeds of sale are reinvested into other business assets); and

(c) specific hold-over relief for business assets (which allows the accrued gains arising on a lifetime gift of property to another individual to be deferred and assumed by the donee).

2. Losses from FHLs will not be able to be set against other income (e.g. other trading or employment income).
3. Capital allowances would not be available (instead there will be 'wear and tear' allowance).
4. Income from FHL will no longer be 'relevant earnings' for pension purposes (which could affect those who have no other trading or employment income).

The way forward for the holiday business

From the practical commercial viewpoint, the owner of the accommodation has to decide what direction they want to take their holiday business – landlord or viable, economic commercial undertaking (trade)?

So what are the problems of the 'A' word – the adventure in the nature of a trade?

1. A true commercial business is as 'it says on the tin' an adventure – an undertaking that involves risks and service to the client.
2. Class 4 National insurance (NIC). As a business, when the profits exceed a certain level then Class 4 NIC is due, although there are deferments for those with Class 1 earnings through employment and retirement age advantages.

Tax planning – which tax is the driver?

If it is accepted the FHL rule book is thrown away from 6 April 2010 and when the birth of the Furnished Holiday Business (FHB) takes place the owners of the property must consider what the main drivers are for wanting FHL tax relief and the tax reliefs that surround a business providing holiday accommodation and use this to help their decision-making accordingly.

Inheritance tax (IHT)

Elderly owners of holiday cottages could well be very driven by the possible IHT reliefs, but IHT reliefs were not part of the FHL package.

IHT relief will depend on 'level and type of services' provided to holidaymakers, e.g. provision of meals, cleaning and hotel type services. See IHTM 25278, which confirms that HMRC are scrutinising claims for BPR on holiday lettings.

On a farm, holiday lettings may be eligible under *Farmer and Another (Executors of Farmer Deceased) v CIR* [1999] STC SCD 321 SpC 216 principles and now the *Earl of Brander (Representative of Fourth Earl of Balfour) v HMRC Commrs* [2009] UK FTT 101

as part of a larger business. Beware a separate 'person', e.g. farmer's wife is carrying on business for VAT reasons, i.e. to not charge VAT on the holiday service.

Case law suggests that in order to qualify for BPR, it might be necessary to own a number of properties.

IHT relief is normally allowed on FHLs where the following is in place:

- FHLs – the lettings are short term (for example, weekly, fortnightly); and
- The owner – either himself or through an agent such as a relative or housekeeper – was substantially involved with the holidaymaker(s) in terms of their activities on and from the premises, even if the letting were for part of the year only.

As usual, whether this IHT test will be satisfied will depend on the facts. The question is if such businesses would not be excluded by the *Inheritance Tax Act* 1984 (IHTA 1984), s.105(3). The criterion is where the owner (either himself or through agents), 'was substantially involved with the holidaymaker(s) in terms of their activities on and from the premises'. The key issue in order for cottage owners to secure maximum tax reliefs is to be involved in the actual services provided.

Risk areas that might jeopardise the IHT claim are:

- Where no services are provided to holidaymakers;
- Where lettings are to friends and relatives; and
- Longer-term lettings (including assured shortholds).

Let us look at the IHTM Manual:

IHTM25278 – Caravan sites and furnished lettings: Holiday Lettings

In the past we have thought that business property relief would normally be available where:

- *The lettings were short term, and*
- *The owner, either himself or through an agent such as a relative, was substantially involved with the holidaymakers in terms of their activities on and from the premises.*

Recent advice from Solicitor's Office has caused us to reconsider our approach and it may well be that some cases that might have previously qualified should not have done so. In particular we will be looking more closely at the level and type of services, rather than who provided them.

Until further notice any case involving a claim for business property relief on a holiday let should be referred to the Technical Team (Litigation) for consideration at an early stage.

Is this a good time to pass the holiday accommodation to the next generation? If it is considered that an 'adventure in the nature of trade' and 'business' can be established for an elderly taxpayer, is the opportunity to pass the property to the next generation now?

CGT

The apparent CGT negatives of the change from 6 April 2010 have been presented earlier and the CGT planning point regarding the holdover relief is set out below:

Note that until 5 April 2010, CGT holdover relief will be available under s.165 TCGA 1992 if 'trading conditions' (availability for letting and actual short lettings for holidays) are satisfied (s.241 TCGA 1992). Is there a case for potentially exempt transfer (PET) to avoid arguments about BPR?

However, it is likely that the CGT advantages, especially rollover, i.e. being able to roll the gain into another property, will be lost and this presents a planning opportunity before 5 April 2010.

Those most adversely affected by the CGT changes will be owners of properties with development potential or large potential gains that they plan to realise in the near future. The choices would have to be to ensure a robust business classification or consider action before 5 April 2010 when the CGT reliefs are still available.

Income tax

The loss of capital allowances and the move to wear and tear or the renewals basis must be considered and risk/cost assessed. The largest disadvantage of the FHL rule change has to be the loss of the ability to offset the income tax losses against total income. In order to mitigate this disadvantage the cottage owner must make a robust move toward the genuine trade or look at the reasons for the loss, e.g. loan interest, non-commercial transactions, areas of excessive expenditure. An action plan could be:

1. Loans – repay from other investments? Consider total restructure.
2. Expenditure – look at timing, consider incurring maximum FHL expenditure prior to 5 April 2010.
3. Commerciality. Review all non-commercial arrangements, look at any method of improving the commercial approach and evidence all attempts at the business direction.

It is considered that possibly some FHL loss claims have been allowed that should have come under HMRC scrutiny. Perhaps those in this position should not 'protest and shout' too much!

VAT

The FHL rules did not apply to VAT so, in theory, the cottage owner is stuck with the problem regardless of 6 April 2010, but a change is being lobbied, i.e. that there should be no VAT charged if the income is letting property. The word 'consistency' comes to mind.

There are strong arguments to maximise the input VAT claim prior to 5 April 2010. However, some FHL property might convert back to normal residential lets and VAT planning around this action must be considered.

Loans

FHL/FHB and loan planning should be considered in the round. Interest is allowed for income tax rules based on the PURPOSE of the loan whereas for IHT purposes the loan should be allocated against the property it is secured on. Loans secured on non-business property are efficient and need real contemplation in the restructuring moving forward.

IHT – a tax case waiting to happen?

It is considered by many that an FHL/FHB IHT is a tax case waiting to be heard by HMRC Tax Tribunal.

HMRC would no doubt like to choose a hopeless BPR claim that can be 'walked all over' and show why the idea of FHLs qualify as a 'non-investment business'. It is therefore essential that the FHL or FHB case that goes before the Revenue Tribunal must be strong. HMRC would like to see FHLs put firmly in the claws of s.105(3), but this insults the real holiday cottage businesses that exist in the UK. If any BPR case looks like appearing before the Revenue Tribunal, the UK tourist authorities must put all their energy into fighting the case.

Summary

There are a large amount of FHBs in the UK that need to be recognised as a business now. Rethink, restructure and register the business with HMRC/Contributions Agency as a trade using form CWF1 (check HMRC website) when and if the total rethink and restructure is carefully in place. For the property that will stay as a 'FHL', there is a lot of planning to be undertaken by 5 April 2010. ■